

**Statement of John P. Murphy, Director, Northeast Region  
National Association of Mutual Insurance Companies  
H.B 6920, An Act Concerning Revisions to the Property and Casualty Statutes**

The National Association of Mutual Insurance Companies ("NAMIC") **opposes** H.B. 6920, An Act Concerning Revisions to the Property and Casualty Statutes.

NAMIC is the largest property/casualty insurance trade association in the country. Our 1,400 member companies serve more than 135 million auto, home and business policyholders, and write more than \$196 billion in annual premiums. NAMIC members write approximately 49% of the property insurance market in Connecticut.

While NAMIC does not object to the proposed grammatical changes in Section 1 of the bill, all of the other sections of the bill will significantly and adversely affect the homeowners market in Connecticut by imposing counterproductive restrictions on the underwriting of property insurance—to the ultimate detriment of Connecticut consumers.

The essence of insurance lies in identifying the risk presented and developing a price that reflects that exposure. Underwriting is the mechanism that allows insurers to do just that. Restricting the ability of insurers to underwrite will have significant consequences for individual consumers and the larger insurance marketplace.

NAMIC's views on the vital role of underwriting are fully addressed in Dr. Robert Detlefsen's paper entitled *The Case for Underwriting Freedom: How Competitive Risk Analysis Promotes Fairness and Efficiency in Property/ Casualty Insurance Markets*. In that treatise Dr. Detlefsen noted that when insurers can freely underwrite consumers will benefit from:

- **Equitable Pricing:** "An insurer whose risk classifications are more refined than those of its competitors will be able to more closely align premiums with the actual level of risk that a policyholder presents." Conversely, if insurers are limited in their ability to underwrite, the price of the product becomes distorted and subsidization occurs---and some consumers will be paying more than their risk warrants.
- **Incentives for Risk Reduction:** "Competitive risk assessment and classification provide incentives for high risk individuals to take action and control losses, because doing so may result in lower premiums." Consumers whose properties present significant loss exposure are economically encouraged to take steps that will mitigate their loss exposure. Having these incentives available can help keep an insurance market stable and viable. If these mitigation measures are not available or their use discouraged by the state, the risk may be too great for carriers and availability of insurance can become a problem for consumers.

A copy of the Executive Summary of Dr. Detlefsen's paper is attached. The full report can be viewed at: <http://www.namic.org/pdf/040916UnderwritingPaper.pdf>

H.B. 6920 would severely restrict the underwriting ability of property/casualty insurers by limiting the use of territories in underwriting and rating homeowners' policies, the minimum coverage amounts and deductibles. Further, the requirement of a uniform, state-wide deductible amount ignores the real and substantial impact that geography has on risk exposure. Enactment of this legislation will have a deleterious effect on the overall insurance market and ultimately on consumers.

# Issue Analysis

A Public Policy Paper of the National Association of Mutual Insurance Companies

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## The Case for Underwriting Freedom: How Competitive Risk Analysis Promotes Fairness and Efficiency in Property/Casualty Insurance Markets

By Robert Detlefsen, Ph.D.  
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### Executive Summary

In many states, property insurance prices are artificially manipulated through government regulation, ostensibly to make insurance more affordable and available to consumers. However, regulation that curtails insurers' freedom to set prices stifles competition and deprives consumers of the benefits that naturally flow from competition. The most obvious form of insurance price regulation is state-administered "rating laws," which require insurers to seek the approval of state insurance departments whenever they wish to raise or lower premiums. However, government-imposed underwriting restrictions – rules that curtail the ability of insurers to assess and classify risk – also strongly affect the price that consumers pay for insurance. Regulation that limits the ability of insurers to engage in risk assessment and classification has far-reaching implications for the entire insurance system.

### Underwriting Freedom Benefits Consumers and Society

In jurisdictions where underwriting freedom prevails, insurers compete by trying to assess individual risks more accurately than their rivals do, and by refining their systems of risk classification, which permits them to more precisely forecast the losses that any given individual is likely to experience. Competitive, risk-based underwriting facilitates fairness in pricing, prudent conduct, widespread availability of coverage, and risk sharing among insurers:

- **Competitive Underwriting Leads to Equitable Pricing.** An insurer whose risk classifications are more refined than those of its competitors will be able to more closely align premiums with the actual level of risk that a policyholder presents. Low-risk individuals will be grouped together and offered premiums that are lower than those offered by insurers who lack accurate risk classification systems. High-risk individuals will be similarly isolated and charged higher premiums that reflect their higher loss costs. If other insurers do not respond by refining their own classification systems, they will lose their low-risk policyholders to their competitor's offer of lower premiums. Competitive underwriting is thus critical to insurers' ability to offer the lowest possible price to each insured, based on the level of risk he presents.

- **Competitive Underwriting Creates Incentives for Risk Reduction.** Competitive risk assessment and classification provide incentives for high-risk individuals to take actions to control losses, because doing so may result in lower premiums. Further, since risk classification involves the pooling of large numbers of similar risks, the insurer is often better able than any individual insured to discover less risky courses of conduct than those its insureds currently follow. Thanks to their superior access to loss experience statistics and greater ability to finance

**NAMIC**

TURNING ISSUES INTO POSITIVE RESULTS

The National Association of Mutual Insurance Companies is a full-service trade association with more than 1,400 member companies that underwrite 43 percent (\$194.6 billion) of the property/casualty insurance in the United States.

**While competition is generally most intense for low-risk insureds, insurers seeking to improve their market penetration will also wish to compete for high-risk insureds within the same market.**

research into loss prevention methods, insurers may be able to suggest specific changes in behavior that will reduce risk and lower premiums.

- **Competitive Underwriting Increases the Availability of Insurance.** To market its products effectively, an insurer must utilize a risk classification system that will allow it to offer insurance to as many potential customers as possible. While competition is generally most intense for low-risk insureds, insurers seeking to improve their market penetration will also wish to compete for high-risk insureds within the same market. Increased market penetration provides economies of scale in the marketing and distribution of insurance, as it does for any product. Competitive risk classification therefore serves to increase the availability of insurance even for high-risk individuals, because the economic advantages of superior market penetration will accrue to those insurers whose refined risk classification systems permit them to price coverage in accordance with the expected costs of each identifiable class of risks within the markets they serve.

- **Competitive Underwriting Facilitates Risk Sharing Among Insurers.** By accurately assessing particular risks, insurers can avoid situations in which they absorb more of a particular kind of risk than they are capable of indemnifying, effectively sharing such risk with other insurers. For example, competitive underwriting among insurers has led to the development of sophisticated risk-assessment techniques such as catastrophe risk modeling, which allows individual property insurers to avoid over-concentration in geographic areas prone to natural disasters.

### **Negative Consequences of Restrictions on Underwriting Freedom**

Government restrictions on underwriting freedom ostensibly guard against unfair

business practices and ensure that insurance will be available to meet market demand. In many instances, however, these regulatory interventions only create dysfunctional market conditions that are detrimental to insurance consumers. Among the more harmful distortions to the competitive insurance system caused by underwriting restriction are adverse selection, moral hazard, and cross-subsidies:

- **Adverse Selection.** Adverse selection occurs when low-risk insureds purchase less coverage, and high-risk insureds purchase more coverage, than they would if the price of insurance more closely reflected the expected loss for each group. When an insurer is unable to distinguish between individuals who have a low probability of experiencing a loss – either because it lacks the ability to accurately assess and classify risk, or because it is prevented from doing so by regulation – adverse selection is the likely result.

- **Moral Hazard.** Underwriting restrictions that prevent insurers from accurately assessing risk can create incentives for policyholders to conduct their affairs in a manner that is less risk averse than if they had no insurance. The most effective method of addressing moral hazard is to accurately assess and classify risk, varying the price of coverage according to the expected loss of each class of insureds. By making it more difficult for insurers to deal with the problem of moral hazard, restrictions on underwriting freedom increase overall claim costs, thereby driving up the price of coverage for all insureds.

- **Cross-Subsidies.** Underwriting restrictions weaken the link between expected loss costs and premiums, creating cross-subsidies that flow from low-risk insureds to high-risk insureds. In addition to the injustice entailed by such compulsory wealth transfers, cross-subsidization of insurance rates has a number of adverse consequences. When high-risk individuals

do not pay the full marginal costs they impose on the insurance system, they lack incentive to take precautions to avoid loss. The net effect of misguided attempts to lower premiums for high-risk individuals through cross-subsidies is likely to be an increase in accident rates and insurance loss costs, adding to the inflationary pressures on insurance premiums.

## Conclusion

The efficiencies that result from competitive, risk-based underwriting lead to increased price competition, and make possible the development of new coverage options tailored to the specific needs of particular consumers. By eschewing underwriting restrictions and allowing competitive insurance markets to flourish, state regulators would realize their common goal of ensuring that property insurance rates are “adequate, not excessive, and not unfairly discriminatory.” Insurance rates that are determined by competition among insurers to assess risk with the greatest possible rigor, and to group similarly situated insureds into precisely constructed risk classes, cannot, by definition, be unfairly discriminatory. Nor could rates established through competitive, risk-based underwriting be considered “excessive,” because the same competitive forces that promote underwriting accuracy also conspire to drive down prices. Far from improving the lot of property insurance consumers, government-imposed underwriting restrictions prevent consumers from enjoying the full range of benefits that come from unfettered competition.